



STATE OF CALIFORNIA

**STATE BOARD OF EQUALIZATION**

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**October 18, 2013**

**To Interested Parties:**

**Notice of Proposed Regulatory Action**

**The State Board of Equalization Proposes to Adopt Amendments to  
California Code of Regulations, Title 18, Section 1502,  
*Computers, Programs, and Data Processing***

**NOTICE IS HEREBY GIVEN**

The State Board of Equalization (Board), pursuant to the authority vested in it by Revenue and Taxation Code (RTC) section 7051, proposes to adopt amendments to subdivision (f)(1) of California Code of Regulations, title 18, section (Regulation) 1502, *Computers, Programs, and Data Processing*, which prescribes the application of sales and use tax to the sale or lease of prewritten programs and maintenance contracts sold in connection with the sale or lease of prewritten programs. The proposed amendments to Regulation 1502, subdivision (f)(1)(C) clarify that a maintenance contract sold in connection with the sale or lease of a prewritten program, including an optional maintenance contract subject to tax at 50 percent of the lump-sum charge, may provide that the purchaser is entitled to receive a backup copy of the same or similar prewritten program recorded on tangible storage media, so that the purchaser may use the backup copy to restore the prewritten program. The proposed amendments to Regulation 1502, subdivision (f)(1)(D) clarify that subdivision (f)(1)(C)'s provisions regarding the taxation of optional maintenance contracts apply to optional maintenance contracts sold in connection with nontaxable electronic download and load-and-leave transactions described in subdivision (f)(1)(D).

**PUBLIC HEARING**

The Board will conduct a meeting in Room 121, at 450 N Street, Sacramento, California, on December 17-19, 2013. The Board will provide notice of the meeting to any person who requests that notice in writing and make the notice, including the specific agenda for the meeting, available on the Board's Website at [www.boe.ca.gov](http://www.boe.ca.gov) at least 10 days in advance of the meeting.

A public hearing regarding the proposed regulatory action will be held at 9:30 a.m. or as soon thereafter as the matter may be heard on December 17, 18, or 19, 2013. At the hearing, any interested person may present or submit oral or written statements, arguments, or contentions regarding the adoption of the proposed amendments to Regulation 1502.

## **AUTHORITY**

RTC section 7051

## **REFERENCE**

RTC sections 995.2, 6006, 6007, 6010, 6010.9, 6011, 6012, 6015, and 6016

## **INFORMATIVE DIGEST/POLICY STATEMENT OVERVIEW**

### Current Law

Subdivision (f)(1) of Regulation 1502 prescribes the application of sales and use tax to the sale or lease of prewritten programs and maintenance contracts sold in connection with the sale or lease of prewritten programs. Regulation 1502, subdivision (f)(1) explains that prewritten programs may be recorded on tangible storage media or coding sheets and provides that tax applies to the sale or lease of storage media or coding sheets on which or into which prewritten programs have been recorded, coded, or punched. However, Regulation 1502, subdivision (f)(1)(D) provides that the sale or lease of a prewritten program is not a taxable transaction if the program is “transferred [in an electronic download transaction] by remote telecommunications from the seller’s place of business, to or through the purchaser’s computer and the purchaser does not obtain possession of any tangible personal property, such as storage media, in the transaction.” Subdivision (f)(1)(D) also provides that the sale of a prewritten program is not a taxable transaction if the program is “installed by the seller on the customer’s computer [in a load-and-leave transaction] except when the seller transfers title to or possession of storage media or the installation of the program is a part of the sale of the computer.”

The first paragraph in Regulation 1502, subdivision (f)(1)(C), describes the characteristics of maintenance contracts. It currently provides that:

Maintenance contracts sold in connection with the sale or lease of prewritten computer programs generally provide that the purchaser will be entitled to receive, during the contract period, storage media on which prewritten program improvements or error corrections have been recorded. The maintenance contract also may provide that the purchaser will be entitled to receive, during the contract period, telephone or on-site consultation services.

Prior to January 1, 2003, all of the charges for optional maintenance contracts were generally taxable because Regulation 1502, subdivision (f)(1)(C) provided that “If the purchase of the

maintenance contract is optional with the purchaser, but the purchaser does not have the option to purchase the consultation services in addition to the sale or lease of storage media containing program improvements or error corrections, then the charges for the consultation services are taxable as part of the sale or lease of the storage media.” However, in 2002, the Board amended Regulation 1502, subdivision (f)(1)(C) to recognize that optional maintenance contracts often involve both the sale or lease of taxable tangible personal property and the provision of nontaxable services, and establish the bright-line rule that only 50 percent of the lump-sum charge for an optional maintenance contract is for the sale of taxable tangible personal property for reporting periods beginning on or after January 1, 2003. The last two paragraphs in Regulation 1502, subdivision (f)(1)(C), currently provide as follows:

For reporting periods commencing on or after January 1, 2003, if the purchase of the maintenance contract is optional with the purchaser, that is, if the purchaser may purchase the prewritten software without also purchasing the maintenance contract, and there is a single lump sum charge for the maintenance contract, 50 percent of the lump sum charge for the maintenance contract is for the sale of tangible personal property and tax applies to that amount; the remaining 50 percent of the lump sum charge is nontaxable charges for repair.

If no tangible personal property whatsoever is transferred to the customer during the period of the maintenance contract, tax does not apply to any portion of the charge. Tax does not apply to a separately stated charge for consultation services if the purchaser is not required to purchase those services in order to purchase or lease any tangible personal property, such as a prewritten computer program or a maintenance contract.

Effects, Objectives, and Benefits of the Proposed Amendments to Regulation 1502, subdivision (f)(1)(C) and (D)

*Need for Clarification*

Board staff thought that some retailers were currently selling or leasing prewritten programs via electronic download and/or load-and-leave transactions and also offering to separately sell their customers optional maintenance contracts that entitle the customers to receive a backup copy of the same or similar prewritten programs recorded on tangible storage media, which the customers could use to restore lost or corrupted data. Board staff thought that, when a customer purchased a prewritten program and maintenance contract in this type of paired transaction, there may be some confusion as to:

- Whether the retailer’s charge for the prewritten program that was sold or leased in the electronic download or load-and-leave transaction is a nontaxable charge under Regulation 1502, subdivision (f)(1)(D); and

- Whether the maintenance contract can be properly characterized as “optional” so that only 50 percent of the lump-sum charge for the maintenance contract is taxable under Regulation 1502, subdivision (f)(1)(C).

Board staff thought that part of the confusion was due to the first paragraph of Regulation 1502, subdivision (f)(1)(C), which specifies that maintenance contracts generally provide that the purchaser is entitled to receive storage media upon which “improvements” and “error corrections” are recorded, and the fact that it is not entirely clear whether a backup copy of a prewritten program is included in the references to “improvements” and “error corrections.” Board staff also thought that part of the confusion was due to the fact that there are currently no provisions in Regulation 1502, subdivision (f)(1)(C) or (D) that expressly indicate that nontaxable electronic download and load-and-leave transactions may be appropriately paired with optional maintenance contracts that entitle customers to receive tangible storage media and are subject to tax at 50 percent of the lump-sum charge.

As a result, Board staff raised the issue during the Board’s January 15, 2013, Business Taxes Committee meeting. Staff recommended that the Board authorize staff to conduct one focused interested parties meeting regarding clarifying amendments to Regulation 1502 to address the issue. And, the Board unanimously voted to approve staff’s recommendation.

#### *Interested Parties Process*

Board staff subsequently reviewed the 2002 amendments adding the second and third paragraphs to Regulation 1502, subdivision (f)(1)(C), which are quoted above, and staff determined that the 2002 amendments were intended to create a bright-line rule that only 50 percent of the lump-sum charge for an optional maintenance contract that entitles the purchase to receive tangible personal property is taxable. In addition, staff determined that the language in the first paragraph of Regulation 1502, subdivision (f)(1)(C), was intended to generally describe maintenance contracts, including maintenance contracts that entitle purchases to receive tangible personal property, such as storage media. Staff did not see any indication that the language in the first paragraph of Regulation 1502, subdivision (f)(1)(C) was intended to limit the types of tangible personal property that can be transferred under maintenance contracts, including optional maintenance contracts.

Further, staff found that when the Board adopted the 2002 amendments to Regulation 1502, subdivision (f)(1)(C), the Board intended for optional maintenance contracts that entitle customers to receive tangible personal property to be taxed the same way. Staff did not see any indication that the Board intended for some optional maintenance contracts sold in connection with the sale or lease of prewritten programs to be taxed differently merely because they provide that the customer is entitled to receive storage media containing a backup copy of a prewritten program, so that the purchaser may use the backup copy to restore lost or corrupted data from the original prewritten program to which the maintenance contract relates, as opposed to other tangible personal property.

Furthermore, staff did not find any indication that when the Board adopted the 2002 amendments to Regulation 1502, subdivision (f)(1)(C), the Board intend to limit the application of subdivision (f)(1)(C)'s provisions to optional maintenance contracts sold in connection with taxable sales and leases of prewritten programs, or otherwise prohibit the provisions from applying to optional maintenance contracts sold in connection with nontaxable electronic download and load-and-leave transactions described in subdivision (f)(1)(D). Also, staff could not find any reason why subdivision (f)(1)(C)'s provisions should be limited to optional maintenance contracts sold in connection with taxable purchases of prewritten programs recorded on tangible storage media, at this time.

As a result, Board staff drafted amendments to Regulation 1502, subdivision (f)(1)(C) that would have the effect and accomplish the objective of clarifying that when a maintenance contract, including an optional maintenance contract, is sold in connection with the sale or lease of a prewritten program, the maintenance contract may include a backup copy of the same or similar prewritten program recorded on tangible storage media, so that the purchaser may use the backup copy to restore lost or corrupted data. Board staff also drafted amendments to Regulation 1502, subdivision (f)(1)(D) that would have the effect and accomplish the objective of clarifying that subdivision (f)(1)(C) applies to optional maintenance contracts sold in connection with nontaxable transactions described in subdivision (f)(1)(D).

Next, staff distributed the draft amendments to the interested parties and discussed the draft amendments at an interested parties meeting on March 6, 2013. During the March 6, 2013, interested parties meeting, Mr. Mark Nebergall, President of the Software Finance & Tax Executives Council, expressed his understanding that backup copies of prewritten programs are simply used to restore prewritten programs, rather than lost or corrupted data, as stated in staff's draft amendments to Regulation 1502, subdivision (f)(1)(C), and recommended that the amendments to subdivision (f)(1)(C) be revised accordingly. In addition, Board staff received a March 22, 2013, letter from Mr. Nebergall, which he sent on behalf of the California business community. In the letter, Mr. Nebergall reiterated his comments from the March 6, 2013, interested parties meeting, and indicated that the California business community does not oppose the draft amendments to Regulation 1502, subdivision (f)(1)(C) and (D) with the revision he previously requested. Therefore, Board staff agreed to consider Mr. Nebergall's recommendation to revise the draft amendments to subdivision (f)(1)(C) to specify that backup copies of prewritten programs may be used to restore prewritten programs, rather than lost or corrupted data.

*August 13, 2013, Business Taxes Committee Meeting*

Board staff subsequently prepared Formal Issue Paper 13-007, which recommended that the Board propose to adopt staff's draft amendments to Regulation 1502, subdivision (f)(1)(C) with the change requested by Mr. Nebergall, and also propose to adopt staff's draft amendments to Regulation 1502, subdivision (f)(1)(D) without any changes. The Board considered staff's recommendation during the August 13, 2013, Business Taxes Committee meeting, and, at the conclusion of the meeting, the Board Members unanimously voted to propose the amendments to

Regulation 1502, subdivision (f)(1)(C) and (D) recommended in the formal issue paper. The Board determined that the proposed amendments to Regulation 1502 would have the effects and accomplish the objectives of clarifying that:

- Tax applies to 50 percent of the lump-sum charge for optional maintenance contracts that entitle customers to receive a backup copy of a prewritten program recorded on tangible storage media; and
- Nontaxable electronic download and load-and-leave transactions may be appropriately paired with separate optional maintenance contracts that entitle customers to receive tangible storage media and are subject to tax at 50 percent of the lump-sum charge.

The Board anticipates that the proposed amendments to Regulation 1502 will provide the following benefits:

- Eliminate confusion by clarifying to the public and staff that a backup copy of a prewritten program recorded on tangible storage media may be included in a maintenance contract sold in connection with the sale or lease of the same prewritten program;
- Provide clarification to the public and staff that taxable optional maintenance contracts are still taxed the same, even if they include a backup copy of a prewritten program recorded on tangible storage media; and
- Maintain the bright-line rule that 50 percent of the lump-sum charge for an optional maintenance contract that entitles the customer to receive tangible personal property is taxable, even when such a contract is paired with a nontaxable electronic download or load-and-leave transaction.

The Board has performed an evaluation of whether the proposed amendments to Regulation 1502, subdivision (f)(1) are inconsistent or incompatible with existing state regulations and determined that the proposed amendments are not inconsistent or incompatible with existing state regulations. This is because Regulation 1502, subdivision (f)(1) contains the only provisions in the state's regulations that specifically prescribe the application of sales and use tax to the sale or lease of prewritten programs and maintenance contracts sold in connection with the sale or lease of prewritten programs, and the proposed amendments are consistent with the existing provisions of Regulation 1502, subdivision (f)(1). In addition, the Board has determined that there are no comparable federal regulations or statutes to Regulation 1502, subdivision (f)(1) or the proposed amendments to Regulation 1502, subdivision (f)(1).

## **NO MANDATE ON LOCAL AGENCIES AND SCHOOL DISTRICTS**

The Board has determined that the adoption of the proposed amendments to Regulation 1502 will not impose a mandate on local agencies or school districts, including a mandate that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code.

**NO COST OR SAVINGS TO STATE AGENCIES, LOCAL AGENCIES, AND SCHOOL DISTRICTS**

The Board has determined that the adoption of the proposed amendments to Regulation 1502 will result in no direct or indirect cost or savings to any state agency, any cost to local agencies or school districts that is required to be reimbursed under part 7 (commencing with section 17500) of division 4 of title 2 of the Government Code, other non-discretionary cost or savings imposed on local agencies, or cost or savings in federal funding to the State of California.

**NO SIGNIFICANT STATEWIDE ADVERSE ECONOMIC IMPACT DIRECTLY AFFECTING BUSINESS**

The Board has made an initial determination that the adoption of the proposed amendments to Regulation 1502 will not have a significant, statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states.

The adoption of the proposed amendments to Regulation 1502 may affect small business.

**NO COST IMPACTS TO PRIVATE PERSONS OR BUSINESSES**

The Board is not aware of any cost impacts that a representative private person or business would necessarily incur in reasonable compliance with the proposed action.

**RESULTS OF THE ECONOMIC IMPACT ANALYSIS REQUIRED BY GOVERNMENT CODE SECTION 11346.3, SUBDIVISION (b)**

The Board has prepared the economic impact analysis required by Government Code section 11346.3, subdivision (b)(1), and included it in the initial statement of reasons. The Board has determined that the adoption of the proposed amendments to Regulation 1502 will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create or expand business in the State of California. Furthermore, the Board has determined that the adoption of the proposed amendments to Regulation 1502 will not affect the benefits of Regulation 1502 to the health and welfare of California residents, worker safety, or the state's environment.

**NO SIGNIFICANT EFFECT ON HOUSING COSTS**

The adoption of the proposed amendments to Regulation 1502 will not have a significant effect on housing costs.

## **DETERMINATION REGARDING ALTERNATIVES**

The Board must determine that no reasonable alternative considered by it or that has been otherwise identified and brought to its attention would be more effective in carrying out the purpose for which the action is proposed, would be as effective and less burdensome to affected private persons than the proposed action, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provision of law than the proposed action.

## **CONTACT PERSONS**

Questions regarding the substance of the proposed regulation should be directed to Bradley M. Heller, Tax Counsel IV, by telephone at (916) 323-3091, by e-mail at [Bradley.Heller@boe.ca.gov](mailto:Bradley.Heller@boe.ca.gov), or by mail at State Board of Equalization, Attn: Bradley M. Heller, MIC:82, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0082.

Written comments for the Board's consideration, notice of intent to present testimony or witnesses at the public hearing, and inquiries concerning the proposed administrative action should be directed to Mr. Rick Bennion, Regulations Coordinator, by telephone at (916) 445-2130, by fax at (916) 324-3984, by e-mail at [Richard.Bennion@boe.ca.gov](mailto:Richard.Bennion@boe.ca.gov), or by mail at State Board of Equalization, Attn: Rick Bennion, MIC:80, 450 N Street, P.O. Box 942879, Sacramento, CA 94279-0080.

## **WRITTEN COMMENT PERIOD**

The written comment period ends at 9:30 a.m. on December 17, 2013, or as soon thereafter as the Board begins the public hearing regarding the adoption of the proposed amendments to Regulation 1502 during the December 17-19, 2013, Board meeting. Written comments received by Mr. Rick Bennion at the postal address, email address, or fax number provided above, prior to the close of the written comment period, will be presented to the Board and the Board will consider the statements, arguments, and/or contentions contained in those written comments before the Board decides whether to adopt the proposed amendments to Regulation 1502. The Board will only consider written comments received by that time.

## **AVAILABILITY OF INITIAL STATEMENT OF REASONS AND TEXT OF PROPOSED REGULATION**

The Board has prepared an underscored and strikeout version of the text of Regulation 1502 illustrating the express terms of the proposed amendments. The Board has also prepared an initial statement of reasons for the adoption of the proposed amendments to Regulation 1502, which includes the economic impact analysis required by Government Code section 11346.3, subdivision (b)(1). These documents and all the information on which the proposed amendments are based are available to the public upon request. The rulemaking file is available for public



October 18, 2013

inspection at 450 N Street, Sacramento, California. The express terms of the proposed regulation and the initial statement of reasons are also available on the Board's Website at [www.boe.ca.gov](http://www.boe.ca.gov).

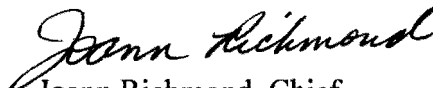
**SUBSTANTIALLY RELATED CHANGES PURSUANT TO GOVERNMENT CODE  
SECTION 11346.8**

The Board may adopt the proposed amendments to Regulation 1502 with changes that are nonsubstantial or solely grammatical in nature, or sufficiently related to the original proposed text that the public was adequately placed on notice that the changes could result from the originally proposed regulatory action. If a sufficiently related change is made, the Board will make the full text of the proposed regulation, with the change clearly indicated, available to the public for at least 15 days before adoption. The text of the resulting regulation will be mailed to those interested parties who commented on the original proposed regulation orally or in writing or who asked to be informed of such changes. The text of the resulting regulation will also be available to the public from Mr. Bennion. The Board will consider written comments on the resulting regulation that are received prior to adoption.

**AVAILABILITY OF FINAL STATEMENT OF REASONS**

If the Board adopts the proposed amendments to Regulation 1502, the Board will prepare a final statement of reasons, which will be made available for inspection at 450 N Street, Sacramento, California, and available on the Board's Website at [www.boe.ca.gov](http://www.boe.ca.gov).

Sincerely,

  
Joann Richmond, Chief  
Board Proceedings Division

JR:reb

**Initial Statement of Reasons for  
Proposed Amendments to California Code of Regulations,  
Title 18, Section 1502, *Computers, Programs, and Data Processing***

**SPECIFIC PURPOSE, PROBLEMS INTENDED TO BE ADDRESSED, NECESSITY, AND  
ANTICIPATED BENEFITS**

**Current Law**

Subdivision (f)(1) of California Code of Regulations, title 18, section (Regulation) 1502, *Computers, Programs, and Data Processing*, prescribes the application of sales and use tax to the sale or lease of prewritten programs and maintenance contracts sold in connection with the sale or lease of prewritten programs. Regulation 1502, subdivision (f)(1) explains that prewritten programs may be recorded on tangible storage media or coding sheets and provides that tax applies to the sale or lease of storage media or coding sheets on which or into which prewritten programs have been recorded, coded, or punched. However, Regulation 1502, subdivision (f)(1)(D) provides that the sale or lease of a prewritten program is not a taxable transaction if the program is “transferred [in an electronic download transaction] by remote telecommunications from the seller’s place of business, to or through the purchaser’s computer and the purchaser does not obtain possession of any tangible personal property, such as storage media, in the transaction.” Subdivision (f)(1)(D) also provides that the sale of a prewritten program is not a taxable transaction if the program is “installed by the seller on the customer’s computer [in a load-and-leave transaction] except when the seller transfers title to or possession of storage media or the installation of the program is a part of the sale of the computer.”

The first paragraph in Regulation 1502, subdivision (f)(1)(C), describes the characteristics of maintenance contracts. It currently provides that:

Maintenance contracts sold in connection with the sale or lease of prewritten computer programs generally provide that the purchaser will be entitled to receive, during the contract period, storage media on which prewritten program improvements or error corrections have been recorded. The maintenance contract also may provide that the purchaser will be entitled to receive, during the contract period, telephone or on-site consultation services.

Prior to January 1, 2003, all of the charges for optional maintenance contracts were generally taxable because Regulation 1502, subdivision (f)(1)(C) provided that “If the purchase of the maintenance contract is optional with the purchaser, but the purchaser does not have the option to purchase the consultation services in addition to the sale or lease of storage media containing program improvements or error corrections, then the charges for the consultation services are taxable as part of the sale or lease of the storage media.” However, in 2002, the State Board of Equalization (Board) amended Regulation 1502, subdivision (f)(1)(C) to recognize that optional maintenance contracts often involve both the sale or lease of taxable tangible personal property

and the provision of nontaxable services, and establish the bright-line rule that only 50 percent of the lump-sum charge for an optional maintenance contract is for the sale of taxable tangible personal property for reporting periods beginning on or after January 1, 2003. The last two paragraphs in Regulation 1502, subdivision (f)(1)(C), currently provide as follows:

For reporting periods commencing on or after January 1, 2003, if the purchase of the maintenance contract is optional with the purchaser, that is, if the purchaser may purchase the prewritten software without also purchasing the maintenance contract, and there is a single lump sum charge for the maintenance contract, 50 percent of the lump sum charge for the maintenance contract is for the sale of tangible personal property and tax applies to that amount; the remaining 50 percent of the lump sum charge is nontaxable charges for repair.

If no tangible personal property whatsoever is transferred to the customer during the period of the maintenance contract, tax does not apply to any portion of the charge. Tax does not apply to a separately stated charge for consultation services if the purchaser is not required to purchase those services in order to purchase or lease any tangible personal property, such as a prewritten computer program or a maintenance contract.

#### Proposed Amendments

##### *Need for Clarification*

Board staff thought that some retailers were currently selling or leasing prewritten programs via electronic download and/or load-and-leave transactions and also offering to separately sell their customers optional maintenance contracts that entitle the customers to receive a backup copy of the same or similar prewritten programs recorded on tangible storage media, which the customers could use to restore lost or corrupted data. Board staff thought that, when a customer purchased a prewritten program and maintenance contract in this type of paired transaction, there may be some confusion as to:

- Whether the retailer's charge for the prewritten program that was sold or leased in the electronic download or load-and-leave transaction is a nontaxable charge under Regulation 1502, subdivision (f)(1)(D); and
- Whether the maintenance contract can be properly characterized as "optional" so that only 50 percent of the lump-sum charge for the maintenance contract is taxable under Regulation 1502, subdivision (f)(1)(C).

Board staff thought that part of the confusion was due to the first paragraph of Regulation 1502, subdivision (f)(1)(C), which specifies that maintenance contracts generally provide that the purchaser is entitled to receive storage media upon which "improvements" and "error corrections" are recorded, and the fact that it is not entirely clear whether a backup copy of a prewritten program is included in the references to "improvements" and "error corrections." Board staff also thought that part of the confusion was due to the fact that there are currently no provisions in Regulation 1502, subdivision (f)(1)(C) or (D) that expressly indicate that

nontaxable electronic download and load-and-leave transactions may be appropriately paired with optional maintenance contracts that entitle customers to receive tangible storage media and are subject to tax at 50 percent of the lump-sum charge.

As a result, Board staff raised the issue during the Board's January 15, 2013, Business Taxes Committee meeting. And, recommended that the Board authorize staff to conduct one focused interested parties meeting regarding potential amendments to Regulation 1502 to expressly clarify that when a consumer purchases a prewritten program in an electronic download or load-and-leave transaction that does not include the transfer of tangible storage media, and also purchases a separate optional maintenance contract that includes the transfer of a backup copy of the same or similar prewritten program recorded on tangible storage media, then:

- Tax does not apply to the charge for the prewritten program itself; and
- Tax applies to 50 percent of the lump-sum charge for the optional maintenance contract.

At the conclusion of the January 15, 2013, Business Taxes Committee meeting, the Board unanimously voted to approve staff's recommendation.

#### *Interested Parties Process*

In preparation for the interested parties meeting, Board staff reviewed the 2002 amendments adding the second and third paragraphs to Regulation 1502, subdivision (f)(1)(C), which are quoted above, and staff determined that the 2002 amendments were intended to create a bright-line rule that only 50 percent of the lump-sum charge for an optional maintenance contract that entitles the purchase to receive tangible personal property is taxable. In addition, staff determined that the language in the first paragraph of Regulation 1502, subdivision (f)(1)(C), was intended to generally describe maintenance contracts, including maintenance contracts that entitle purchases to receive tangible personal property, such as storage media. Staff did not see any indication that the language in the first paragraph of Regulation 1502, subdivision (f)(1)(C) was intended to limit the types of tangible personal property that can be transferred under maintenance contracts, including optional maintenance contracts.

Further, staff found that when the Board adopted the 2002 amendments to Regulation 1502, subdivision (f)(1)(C), the Board intended for optional maintenance contracts that entitle customers to receive tangible personal property to be taxed the same way. Staff did not see any indication that the Board intended for some optional maintenance contracts sold in connection with the sale or lease of a prewritten program to be taxed differently merely because they provide that the customer is entitled to receive storage media containing a backup copy of a prewritten program, so that the purchaser may use the backup copy to restore lost or corrupted data from the original prewritten program to which the maintenance contract relates, as opposed to other tangible personal property.

Furthermore, staff did not find any indication that when the Board adopted the 2002 amendments to Regulation 1502, subdivision (f)(1)(C), the Board intend to limit the application of subdivision (f)(1)(C)'s provisions to optional maintenance contracts sold in connection with taxable sales and leases of prewritten programs, or otherwise prohibit the provisions from applying to optional

maintenance contracts sold in connection with nontaxable electronic download and load-and-leave transactions described in subdivision (f)(1)(D). Also, staff could not find any reason why subdivision (f)(1)(C)'s provisions should be limited to optional maintenance contracts sold in connection with taxable purchases of prewritten programs recorded on tangible storage media, at this time.

As a result, Board staff drafted amendments to Regulation 1502, subdivision (f)(1)(C) to clarify that when a maintenance contract, including an optional maintenance contract, is sold in connection with the sale or lease of a prewritten program, the maintenance contract may include a backup copy of the same or similar prewritten program recorded on tangible storage media, so that the purchaser may use the backup copy to restore lost or corrupted data. Board staff also drafted amendments to Regulation 1502, subdivision (f)(1)(D) to clarify that subdivision (f)(1)(C) applies to optional maintenance contracts sold in connection with nontaxable transactions described in subdivision (f)(1)(D). Then, staff distributed the draft amendments to the interested parties and discussed the draft amendments at an interested parties meeting on March 6, 2013.

During the March 6, 2013, interested parties meeting, Mr. Mark Nebergall, President of the Software Finance & Tax Executives Council, expressed his understanding that backup copies of prewritten programs are simply used to restore prewritten programs, rather than lost or corrupted data, as stated in staff's draft amendments to Regulation 1502, subdivision (f)(1)(C), and recommended that the amendments to subdivision (f)(1)(C) be revised accordingly. Mr. Nebergall also expressed his understanding that it is not currently a common business practice for software retailers to provide a backup copy of a prewritten program to their customers as part of an optional maintenance contract.

During the March 6, 2013, interested parties meeting, Board staff agreed to consider Mr. Nebergall's recommendation to revise the draft amendments to subdivision (f)(1)(C) to specify that backup copies of prewritten programs may be used to restore prewritten programs, rather than lost or corrupted data. Staff also explained that the amendments to Regulation 1502 are intended to eliminate confusion regarding the treatment of backup copies of prewritten programs under existing law, and that the clarification may lead to changes in software retailers' current business practices.

In addition, Board staff received a March 22, 2013, letter from Mr. Nebergall, which he sent on behalf of the California business community. In the letter, Mr. Nebergall reiterated his comments from the March 6, 2013, interested parties meeting, and indicated that the California business community does not oppose the draft amendments to Regulation 1502, subdivision (f)(1)(C) and (D) with the revision he previously requested.

#### *August 13, 2013, Business Taxes Committee Meeting*

Board staff subsequently prepared Formal Issue Paper 13-007 and distributed it to the Board Members on August 2, 2013, for consideration at the Board's August 13, 2013, Business Taxes Committee meeting. The formal issue paper recommended that the Board propose to adopt staff's draft amendments to Regulation 1502, subdivision (f)(1)(C) with the change requested by

Mr. Nebergall, and also propose to adopt staff's draft amendments to Regulation 1502, subdivision (f)(1)(D) without any changes. At the conclusion of the August 13, 2013, Business Taxes Committee meeting, the Board Members unanimously voted to propose the amendments to Regulation 1502, subdivision (f)(1)(C) and (D) recommended in the formal issue paper. The Board determined that the proposed amendments to Regulation 1502 are reasonably necessary for the specific purpose of eliminating any problems software retailers, software consumers, or Board staff may have understanding that:

- Tax applies to 50 percent of the lump-sum charge for optional maintenance contracts that entitle customers to receive a backup copy of a prewritten program recorded on tangible storage media; and
- Nontaxable electronic download and load-and-leave transactions may be appropriately paired with separate optional maintenance contracts that entitle customers to receive tangible storage media and are subject to tax at 50 percent of the lump-sum charge.

The Board anticipates that the proposed amendments to Regulation 1502 will provide the following benefits:

- Eliminate confusion by clarifying to the public and staff that a backup copy of a prewritten program recorded on tangible storage media may be included in a maintenance contract sold in connection with the sale or lease of the same prewritten program;
- Provide clarification to the public and staff that taxable optional maintenance contracts are still taxed the same, even if they include a backup copy of a prewritten program recorded on tangible storage media; and
- Maintain the bright-line rule that 50 percent of the lump-sum charge for an optional maintenance contract that entitles the customer to receive tangible personal property is taxable, even when such a contract is paired with a nontaxable electronic download or load-and-leave transaction.

The adoption of the proposed amendments to Regulation 1502 is not mandated by federal law or regulations. There is no previously adopted or amended federal regulation that is identical to Regulation 1502.

#### DOCUMENTS RELIED UPON

The Board relied upon Formal Issue Paper 13-007, the exhibits to the issue paper, and the comments made during the Board's discussion of the issue paper during its August 13, 2013, Business Taxes Committee meeting in deciding to propose the amendments to Regulation 1502 described above.

#### ALTERNATIVES CONSIDERED

The Board considered whether to begin the formal rulemaking process to adopt the proposed amendments to Regulation 1502 at this time or, alternatively, whether to take no action at this time. The Board decided to begin the formal rulemaking process to adopt the proposed

amendments to Regulation 1502 at this time because the Board determined that the proposed amendments are reasonably necessary for the reasons set forth above.

The Board did not reject any reasonable alternative to the proposed amendments to Regulation 1502 that would lessen any adverse impact the proposed action may have on small business or that would be less burdensome and equally effective in achieving the purposes of the proposed action. No reasonable alternative has been identified and brought to the Board's attention that would lessen any adverse impact the proposed action may have on small business, be more effective in carrying out the purposes for which the action is proposed, would be as effective and less burdensome to affected private persons than the proposed action, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provision of law than the proposed action.

INFORMATION REQUIRED BY GOVERNMENT CODE SECTION 11346.2,  
SUBDIVISION (b)(6) AND ECONOMIC IMPACT ANALYSIS REQUIRED BY  
GOVERNMENT CODE SECTION 11346.3, SUBDIVISION (b)

As previously explained, the proposed amendments to Regulation 1502, subdivision (f)(1)(C) and (D) clarify that, under existing law:

- A backup copy of a prewritten program recorded on tangible storage media may be included in a maintenance contract sold in connection with the sale or lease of the same or similar prewritten program;
- Tax still applies to 50 percent of the lump-sum charge for an optional maintenance contract that entitles the purchaser to receive tangible storage media, even if a backup copy of a prewritten program is recorded on the tangible storage media; and
- An optional maintenance contract, subject to tax at 50 percent of the lump-sum charge, may be appropriately paired with a separate nontaxable electronic download or load-and-leave transaction without changing the way tax applies to the electronic download or load-and-leave transaction.

Therefore, the proposed amendments do not change the taxation of prewritten programs or optional maintenance contracts under existing law.

Further, the proposed amendments to Regulation 1502 make it clear that software retailers may include backup copies of prewritten programs recorded on tangible storage media in their optional maintenance contracts, subject to tax at 50 percent of the lump-sum charge, and pair their taxable optional software maintenance contracts with separate nontaxable electronic download or load-and-leave transactions, or both. However, the proposed amendments do not require that software retailers include backup copies of prewritten programs recorded on tangible storage media in their optional maintenance contracts or pair taxable optional maintenance contracts with nontaxable download or load-and-leave transactions. Therefore, the proposed amendments do not impose any costs on software retailers.

Furthermore, the Board understands that, in 2013, software retailers generally sell or lease prewritten programs in nontaxable download or load-and-leave transactions. The Board

understands, based on Mr. Nebergall's comments discussed above, that it is not currently a common business practice for software retailers to provide a backup copy of a prewritten program recorded on tangible storage media to their customers as part of an optional maintenance contract. And, the Board only anticipates that some retailers will choose to include backup copies of prewritten programs recorded on tangible storage media in some of their optional maintenance contracts, subject to tax at 50 percent of the lump-sum charge, pair their taxable optional software maintenance contracts with some of their separate nontaxable electronic download or load-and-leave transactions, or both if there is a business reason for doing so. As a result, the proposed amendments to Regulation 1502 will not have a significant positive or negative effect on software retailers' current business practices, and the Board does not anticipate that software retailers will make significant changes to their current business practices solely due to the proposed clarifying amendments to Regulation 1502.

Therefore, based on these facts and all of the information in the rulemaking file, the Board has determined that the adoption of the proposed amendments to Regulation 1502 will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create or expand business in the State of California.

In addition, Regulation 1502 does not regulate the health and welfare of California residents, worker safety, or the state's environment. Therefore, the Board has also determined that the adoption of the proposed amendments to Regulation 1502 will not affect the health and welfare of California residents, worker safety, or the state's environment.

The forgoing information also provides the factual basis for the Board's initial determination that the adoption of the proposed amendments to Regulation 1502 will not have a significant adverse economic impact on business.

The proposed amendments to Regulation 1502 may affect small business.



**Text of Proposed Amendments to  
California Code of Regulations, Title 18, Section 1502**

**1502. Computers, Programs, and Data Processing.**

(a) In General. "Automatic data processing services" are those rendered in performing all or part of a series of data processing operations through an interacting assembly of procedures, processes, methods, personnel, and computers.

Automatic data processing services may be provided by manufacturers of computers, data processing centers, systems designers, consultants, software companies, etc. In addition, there are banks and other businesses which own or lease computers and use them primarily for their own purposes but occasionally provide services to others. Businesses rendering automatic data processing services will be referred to herein as "data processing firms."

(b) Definition of Terms.

(1) Application. The specific job performance by an automatic data processing installation. For example, data processing for a payroll may be referred to as a payroll application.

(2) Coding. The list, in computer code, of the successive computer instructions representing successive computer operations for solving a specific problem.

(3) Computer. A computer is an electronic device (including word processing equipment and testing equipment) or combination of components, which is programmable and which includes a processor (central processing unit or microprocessor), internal memory, and input and output connections. Manufacturing equipment which incorporates a computer is a computer for purposes of this regulation. However, the term does not include manufacturing equipment which operates under the control of mechanical or electronic accessories, the attachment to the equipment of which is required for the machine to operate. An electronic device otherwise qualifying as a computer remains a computer even though it may be used for information processing, data acquisition, process control or for the control of manufacturing machinery or equipment.

(4) Custom Computer Program and Programming. A computer program prepared to the special order of the customer. A program prepared to the special order of the customer qualifies as a custom program even though it may incorporate preexisting routines, utilities or similar program components. It includes those services represented by separately stated charges for modifications to an existing prewritten program which are prepared to the special order of the customer.

(5) Data Entry (including Encoding). Recording information in or on storage media by punching the holes or inserting magnetic bits to represent letters, digits, and special characters.

(6) Digital Pre-Press Instruction. The creation of original information in electronic form by combining more than one computer program into specific instructions or information necessary to prepare and link files for electronic transmission for output, within the printing industry, to film, plate, or direct to press, which is then transferred on electronic media such as tape or compact disc.

(7) Input. The information or data transferred, or to be transferred, from storage media into the internal storage of the computer.

(8) Output. The information transferred from the internal storage of the computer to storage media or tabulated listing.

(9) Prewritten Program. A program held or existing for general or repeated sale or lease. The term also includes a program developed for in-house use which is subsequently offered for sale or lease as a product.

(10) Program. "Program" is the complete plan for the solution of a problem, i.e., the complete sequence of automatic data processing equipment instructions necessary to solve a problem, and includes both systems and application programs and subdivisions thereof. "Subdivision" includes, without limitation, assemblers, compilers, generators, procedures, functions, routines, and utility programs. "Problem" means and includes any problem that may be addressed or resolved by a program or subdivision; and the "problem" addressed need not constitute the full array of a purchaser's or user's problems, requirements, and desired features. "Problem" further includes, without limitation, any problem associated with: information processing; the manipulation or storage of data; the input or output of data; the transfer of data or programs, including subdivisions; the translation of programs, including subdivisions, into machine code; defining procedures, functions, or routines; executing programs or subdivisions that may be invoked within a program; and the control of equipment, mechanisms, or special purpose hardware.

(11) Proof Listing. A tabulated listing of input.

(12) Source Documents. A document supplied by a customer of a data processing firm from which basic data are extracted (e.g., sales invoice).

(13) Storage Media. Includes hard disks, floppy disks, diskettes, magnetic tape, cards, paper tape, drums and other devices upon which information is recorded.

(c) Basic Applications of Tax.

(1) The transfer of title, for a consideration, of tangible personal property, including property on which or into which information has been recorded or incorporated, is a sale subject to tax.

(2) Charges for producing, fabricating, processing, printing, imprinting or otherwise physically altering, modifying or treating consumer-furnished tangible personal property

(cards, tapes, disks, etc.), including charges for recording or otherwise incorporating information on or into such tangible personal property, are generally subject to tax.

(3) A transfer for a consideration of the title or possession of tangible personal property which has been produced, fabricated, or printed to the special order of the customer, including property on which or into which information has been recorded or incorporated, is generally a sale subject to tax. However, if the contract is for the service of researching and developing original information for a customer, tax does not apply to the charges for the service. The tangible personal property used to transmit the original information is merely incidental to the service.

(4) Charges for the transfer of computer-generated output are subject to tax where the true object of the contract is the output and not the services rendered in producing the output. Examples include artwork, graphics, and designs. However, the transfer by the seller of the original information created by digital pre-press instruction is not subject to tax if the original information is a custom computer program as explained in subdivision (f)(2)(F).

(5) Charges for processing customer-furnished information (sales data, payroll data, etc.) are generally not subject to tax. (For explanation and specific application of tax, see subdivision (d).)

(6) Leases of tangible personal property may be subject to tax under certain conditions. (See Regulation 1660 for application of tax to leases.)

(7) Charges made for the use of a computer, on a time-sharing basis, where access to the computer is by means of remote telecommunication, are not subject to tax. (See subdivision (i).)

(8) Generally, data processing firms are consumers of all tangible personal property, including cards and forms, which they use in providing nontaxable services unless a separate charge is made to customers for the materials, in which case tax applies to the charge made for the materials.

**(d) Manipulation of Customer-Furnished Information as Sale or Service.**

(1) General. Generally tax applies to the conversion of customer-furnished data from one physical form of recordation to another physical form of recordation. However, if the contract is for the service of developing original information from customer-furnished data, tax does not apply to the charges for the service. The tangible personal property used to transmit the original information is merely incidental to the service.

(2) Data Entry and Verification. This covers situations where a data processing firm's agreement provides only for data entry, data verification, and proof listing of data, or any combination of these operations. It does not include contracts under which these services are performed as steps in processing of customer-furnished information as discussed under subdivision (d)(5).

Agreements providing solely for data entry and verification, or data entry providing a proof list and/or verifying of data are regarded as contracts for the fabrication of storage media and sale of proof lists. Charges therefor are taxable, whether the storage media are furnished by the customer or by the data processing firm. Tax also applies to charges for the imprinting of characters on a document to be used as the input medium in an optical character recognition system. The tax application is the same regardless of which type of storage media is used in the operation.

(3) Addressing (Including Labels) for Mailing. Where the data processing firm addresses, through the use of its computer or otherwise, material to be mailed, with names and addresses furnished by the customer or maintained by the data processing firm for the customer, tax does not apply to the charge for addressing. Similarly, where the data processing firm prepares, through the use of its computer or otherwise, labels to be affixed to material to be mailed, with names and addresses furnished by the customer or maintained by the data processing firm for the customer, tax does not apply to the charge for producing the labels, whether or not the data processing firm itself affixes the labels to the material to be mailed. (For the sale of mailing list by the proprietor or such list as a sale of tangible personal property or as a nontaxable addressing, see Regulation 1504 "Mailing-Services.")

(4) Microfilming and Photorecording. Tax applies to charges for microfilming or photorecording except, as provided in subdivision (d)(5), where the microfilming or photorecording is done under a contract for the processing of customer-furnished information. Tax applies to a contract where data on magnetic tape are converted into combinations of alphanumeric printing, curve plotting and/or line drawings, and put on microfilm or photorecording paper.

(5) Processing of Customer-Furnished Information.

(A) "Processing of customer-furnished information" means the developing of original information from data furnished by the customer. Examples of automatic data processing processes which result in original information are summarizing, computing, extracting, sorting and sequencing. Such processes also include the updating of a continuous file of information maintained by the customer with the data processing firm.

(B) "Processing of customer-furnished information" does not include: (1) an agreement providing solely for the reformatting of data or for the preparation of a proof listing or the performance of an edit routine or other pre-processing, (2) the using of a computer as a mere printing instrument, as in the preparation of personalized computer-printed letters, (3) the mere converting of data from one medium to another, or (4) an agreement under which a person undertakes to prepare artwork, drawings illustrations, or other graphic material unless the provisions of subdivision (f)(2)(F) apply regarding digital pre-press instruction and custom computer programs. Additionally, graphic material furnished incidentally to the performance of a service is not subject to tax. For example, graphics furnished in connection with the performance of architectural, engineering, accounting, or similar professional services are not subject to tax. With respect to typography, clip art

combined with text on the same page is considered composed type as explained in Regulation 1541.

(C) Contracts for the processing of customer-furnished information usually provide that the data processing firm will receive the customer's source documents, record data on storage media, make necessary corrections, process the information, and then record and transfer the output to the customer.

Where a data processing firm enters into a contract for the processing of customer-furnished information, the transfer of the original information to the customer is considered to be the rendering of a service. Except as described in subdivisions (c)(8) and (d)(5)(E), tax does not apply to the charges made under contracts providing for the transfer of the original information whether the original information is transferred on storage media, microfilm, microfiche, photorecording paper, input media for an optical character recognition system, punched cards, preprinted forms, or tabulated listing. The breakdown of the total charge into separate charges for each operation involved in processing the customer-furnished information will not change the application of tax.

(D) The furnishing of computer programs and data by the customer for processing under direction and control of the data processing firm will not alter the application of tax, notwithstanding that charges are based on computer time.

(E) Taxable Items. Where a data processing firm has entered into a contract which is regarded as a service contract under subdivision (d)(5)(C) and the data processing firm, pursuant to the contract, transfers to its customer tangible property other than property containing the original information, such as duplicate copies of storage media; inventory control cards for use by the customer; membership cards for distribution by the customer; labels (other than address labels); microfiche duplicates; or similar items for use, tax applies to the charges made for such items. If no separate charge is made, tax applies to that portion of the charge made by the data processing firm which the cost of the additional computer time (if and), cost of materials, and labor cost to produce the items bear to the total job cost.

(F) Additional Copies. When additional copies of records, reports, tabulation, etc., are provided, tax applies to the charges made for the additional copies. "Additional copies" are all copies (other than carbon copies), whether the copies are prepared by rerunning the same program, by using multiple simultaneous printers, by looping a program such that the program is run continuously, by using different programs to produce the same output product, or by other means. Where additional copies are prepared, the tax will be measured by the charge made by the data processing firm to the customer. If no separate charge is made for the additional copies, tax applies to that portion of the gross receipts which the cost of the additional computer time (if any), the cost of materials and labor cost to produce the additional copies bear to the total job cost. Charges for copies produced by means of photocopying, multilithing, or by other means are subject to tax.

(e) Training Services and Materials. Data processing firms provide a number of training services, such as data entry and verification, programming, and specialized training in systems design.

(1) Charges for training services are nontaxable, except as provided in subdivision (g) where the training services are provided as part of the sale of tangible personal property. The data processing firm is the consumer of tangible personal property which is used in training others, or provided to trainees without a separate charge as a part of the training services.

(2) Tax applies to charges for training materials, including books, furnished to trainees for a charge separate from the charge for training services.

(3) Where a person sells tangible personal property, such as computers or programs, and provides training materials to the customer without making an additional charge for the training materials, this is a sale of the training materials. The selling price of the training materials is considered to be included in the sales price of the tangible personal property.

(f) Computer Programs.

(1) Prewritten (Canned) Programs. Prewritten programs may be transferred to the customer in the form of storage media, or by listing the program instructions on coding sheets. In some cases they are usable as written; however, in other cases it is necessary that the program be modified, adapted, and tested to meet the customer's particular needs. Tax applies to the sale or lease of the storage media or coding sheets on which or into which such prewritten (canned) programs have been recorded, coded, or punched.

(A) Tax applies whether title to the storage media on which the program is recorded, coded, or punched, passes to the customer, or the program is recorded, coded, or punched on storage media furnished by the customer. The temporary transfer of possession of a program, for a consideration, for the purpose of direct use or to be recorded or punched by the customer, or by the lessor on the customer's premises, is a lease of tangible personal property. The tax applies unless the property is leased in substantially the same form as acquired by the lessor and the lessor has paid sales tax reimbursement or use tax with respect to the property.

(B) Tax applies to the entire amount charged to the customer. Where the consideration consists of license fees, all license fees, including site licensing and other end users fees, are includable in the measure of tax. Tax does not apply, however, to license fees or royalty payments that are made for the right to reproduce or copy a program to which a federal copyright attaches in order for the program to be published and distributed for a consideration to third parties, even if a tangible copy of the program is transferred concurrently with the granting of such right. Any storage media used to transmit the program is merely incidental.

(C) Maintenance contracts sold in connection with the sale or lease of a prewritten computer programs generally provide that the purchaser will be entitled to receive, during the contract period, storage media on which the prewritten program improvements or

error corrections have been recorded. The maintenance contracts may provide that the purchaser is entitled to receive storage media on which a backup copy of the same or similar prewritten program is recorded, so that the purchaser may use the backup copy to restore the prewritten program. The maintenance contract also may provide that the purchaser will be entitled to receive, during the contract period, telephone or on-site consultation services.

If the purchase of the maintenance contract is not optional with the purchaser, that is, if the purchaser must purchase the maintenance contract in order to purchase or lease a prewritten computer program, then the charges for the maintenance contract are taxable as part of the sale or lease of the prewritten program. Tax applies to any charge for consultation services provided in connection with a maintenance contract except as provided below.

For reporting periods commencing on or after January 1, 2003, if the purchase of the maintenance contract is optional with the purchaser, that is, if the purchaser may purchase the prewritten software without also purchasing the maintenance contract, and there is a single lump sum charge for the maintenance contract, 50 percent of the lump sum charge for the maintenance contract is for the sale of tangible personal property and tax applies to that amount; the remaining 50 percent of the lump sum charge is nontaxable charges for repair.

If no tangible personal property whatsoever is transferred to the customer during the period of the maintenance contract, tax does not apply to any portion of the charge. Tax does not apply to a separately stated charge for consultation services if the purchaser is not required to purchase those services in order to purchase or lease any tangible personal property, such as a prewritten computer program or a maintenance contract.

(D) The sale or lease of a prewritten program is not a taxable transaction if the program is transferred by remote telecommunications from the seller's place of business, to or through the purchaser's computer, and the purchaser does not obtain possession of any tangible personal property, such as storage media, in the transaction. Likewise, the sale of a prewritten program is not a taxable transaction if the program is installed by the seller on the customer's computer except when the seller transfers title to or possession of storage media or the installation of the program is a part of the sale of the computer. Paragraph (C) applies to optional software maintenance contracts sold in connection with nontaxable transactions described in this paragraph.

If the transfer of a prewritten program is a nontaxable transaction, then the seller is the consumer of tangible personal property used to produce written documentation or manuals (including documentation or manuals in machine-readable form) designed to facilitate the use of the program and transferred to the purchaser for no additional charge. If a separate charge is made for the documentation or manuals, then tax applies to the separate charge.

(E) The transfer of a prewritten program on storage media is not a sale for resale when the storage media, or an exact copy, will be used to produce additional copies of the program.

Charges for testing a prewritten program on the purchaser's computer to insure that such a program operates as required are installation charges and are nontaxable

(2) Custom Programs.

(A) Tax does not apply to the sale or lease of a custom computer program, other than a basic operational program, regardless of the form in which the program is transferred. Nor does the tax apply to the transfer of a custom program, or custom programming services performed, in connection with the sale or lease of computer equipment, whether or not the charges for the custom program or programming are separately stated.

(B) However, charges for custom modifications to prewritten program are nontaxable only if the charges for the modifications are separately stated. Otherwise, the charges are taxable as part of the sale of the prewritten program.

When the charges for modification of a prewritten program are not separately stated, tax applies to the entire charge made to the customer for the modified program unless the modification is so significant that the new program qualifies as a custom program. If the prewritten program was previously marketed, the new program will qualify as a custom program, if the price of the prewritten program was 50 percent or less of the price of the new program. If the prewritten program was not previously marketed, the new program will qualify as a custom program if the charge made to the customer for custom programming services, as evidenced in the records of the seller, is more than 50 percent of the contract price to the customer.

(C) Charges for any written documentation or manuals designed to facilitate the use of a custom computer program by the customer are nontaxable, whether separately stated or not. The vendor of the custom computer program is the consumer of the written documentation or manuals, or of any tangible personal property used by the vendor in producing the written documentation or manuals.

(D) A custom computer program includes a program prepared to the special order of a customer who will use the program to produce and sell or lease copies of the program, and the charge for such custom computer program is not subject to tax. Sales or leases of the copies, however, are taxable as sales of prewritten computer programs.

(E) A computer program prepared to the special order of a customer to operate for the first time in connection with a particular basic operating system is a custom computer program even though a different version currently operates in connection with an incompatible basic operating system.



(F) Digital pre-press instruction is a custom computer program under section 6010.9 of the Revenue and Taxation Code, the sale of which is not subject to tax, provided the digital pre-press instruction is prepared to the special order of the purchaser. Digital pre-press instruction shall not, however, be regarded as a custom computer program if it is a “canned” or prewritten computer program which is held or existing for general or repeated sale or lease, even if the digital pre-press instruction was initially developed on a custom basis or for in-house use. The sale of such canned or prewritten digital pre-press instruction in tangible form is a sale of tangible personal property, the retail sale of which is subject to tax.

(g) Service Charges. The following activities are service activities. Charges for the performance of such services are nontaxable unless the services are performed as a part of the sale of tangible personal property.

(1) Designing and implementing computer systems (e.g., determining equipment and personnel required and how they will be utilized).

(2) Designing storage and data retrieval systems (e.g., determining what data communications and high-speed input-output terminals are required).

(3) Consulting services (e.g., study of all or part of a data processing system).

(4) Feasibility studies (e.g., studies to determine what benefits would be derived if procedures were automated).

(5) Evaluation of bids (e.g., studies to determine which manufacturer’s proposal for computer equipment would be most beneficial).

(6) Providing technical help, analysts, and programmers, usually on an hourly basis.

(7) Training Services.

(8) Maintenance of equipment. (See Regulation 1546 for application of tax to maintenance contracts.)

(9) Consultation as to use of equipment.

(h) Pick-up and Delivery Charges. If the data processing firm’s billing is for nontaxable processing of customer-furnished information, the tax will not apply to pick-up and delivery charges. If pick-up and delivery charges are made in conjunction with the sale of tangible personal property or the processing of customer-furnished tangible personal property, the tax will apply to the pick-up charges. Tax will apply to the delivery charges to the extent specified in regulation 1628, “Transportation Charges.”

(i) Rental of Computers. A lease includes a contract by which a person secures for a consideration the use of a computer which is not on his or her premises, if the person or his or

her employees, while on the premises where the computer is located operate the computer, or direct and control its operation. A lease does not include a contract whereby a person secures access by means of remote telecommunication to a computer which is not on his or her premises, if the person or his or her employees operate the computer or direct and control its operation by means of remote telecommunication. (See Regulation 1660 for application of tax to leases.)

Note: Authority cited: Section 7051, Revenue and Taxation Code. Reference: Sections 995.2, 6006, 6007, 6010, 6010.9, 6011, 6012, 6015 and 6016, Revenue and Taxation Code.

## Regulation History

**Type of Regulation:** Sales and Use Tax

Regulation: 1502

Title: 1502, *Computers, Programs, and Data Processing*

**Preparation:** Bradley Heller

**Legal Contact:** Bradley Heller

The proposed amendments to Regulation 1502, *Computers, Programs, and Data Processing*, clarify that a maintenance contract may provide that the purchaser is entitled to receive a backup copy of a prewritten program recorded on tangible storage media and that a taxable optional maintenance contract may be appropriately paired with a nontaxable electronic download or load-and-leave transaction.

### History of Proposed Amendments:

December 17-19, 2013	Public Hearing
October 18, 2013	OAL publication date; 45-day public comment period begins; Interested Parties mailing
October 8, 2013	Notice to OAL
August 13, 2013	Business Tax Committee, Board Authorized Publication (Vote 5-0)

Sponsor: NA

Support: NA

Oppose: NA